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SUBJECT: RUSSIAN GAS SALES IN THE BALTIC REGION - A COOPERATIVE VENTURE

11. (SBU) Summary. The history of the international gas trade from northwest Russia to its Baltic neighbors is an example of an extraordinary smooth and successful shift towards market principles. The main factors that facilitated this were the financial willingness and ability of the Baltic consumers to pay market prices, the amenability of these countries to Gazprom's desire to have a significant stake in their national pipeline operators, and a simple pipeline geography which minimized any outside political considerations. End Summary.

12. (SBU) The Northwest Federal District of Russia is the region through which Russia supplies natural gas to the Baltic states and Finland. The supply network utilizes the pipeline system operated by OOO Gazprom Transgaz Sankt-Peterburg, which is a St. Petersburg-based subsidiary of Gazprom. This pipeline system directly connects Russia's main pipeline network with each of these countries. In 2007, it transmitted 4.4bln cubic meters of gas to Finland, 3.4bln to Lithuania, 1.6bln to Latvia and 1bln cubic meters to Estonia.

13. (SBU) Among the four countries, Finland is both the largest and oldest customer. Finland began receiving Russian gas in 1974 based on a twenty-year contract which had fluctuating prices based on the current market situation. The contract was renewed for an additional twenty years in 1994, and has recently been extended through to 2025. These long-term contracts have provided a stable environment for both Finland and Gazprom, and almost completely eliminated any political calculations from entering into what remains a commercial exercise.

14. (SBU) Unlike the contract with Finland, the supply of Russian gas to the Baltic states during the first years after the collapse of the Soviet Union was based on short-term contracts with fixed prices. These prices were considerably lower than those for other European countries. It is important to note that, throughout the post-Soviet years, Gazprom continued to deliver gas to the Baltic states as stipulated by the contracts and despite various political tensions between the governments. This history of cooperation between Russia and the Baltic states carried over into the mid 2000's, when Latvia, Lithuania and Estonia were required, as part of their EU accession requirements, to adjust the terms and conditions of their contracts with Gazprom to make them more in line with those of other EU countries. Consequently, Gazprom and the Baltic states worked out a three-year transition programs, which saw the introduction of long-term contracts and a gradual shift to market prices. Though the shift meant a doubling of gas prices by the end of the three-year transition period, rapid economic growth in the Baltic states helped ameliorate the rise in costs. The hallmark of the current set up is its stability. There has never been any serious interruption of gas supply to the Baltic states, notwithstanding a few incidences of reduced pressure in the pipeline network at times for several hours due to technical failures. Also, Gazprom officials have often praised the Baltic states as ideal customers for their prompt payments for gas deliveries.

15. (SBU) The Baltic states have also been accepting of Gazprom's

interest in having a large financial stake in their national pipeline operators. In 1993 the Estonian Government allowed Gazprom Transgaz Sankt-Peterburg to participate in the incorporation of Eesti Gaas, the company which operates the Estonian gas pipeline network. Gazprom now owns 37% of Eesti Gaas. Gazprom was also welcomed to participate in the privatization of both the Lithuanian and Latvian national pipeline companies. As a result, Gazprom currently controls 37% of the shares of Lietuvos Dujos in Lithuania and 34% of Latvijas Gaze in Latvia.

¶6. (SBU) The geography of the gas pipelines in the Baltic region also played a role in the peaceful transition from Soviet days. The pipelines generally run directly from Russia to the Baltic states, and the pipelines stop in the recipient countries, with no further downstream foreign customers. Thus, during negotiations between the Baltic states and Russia, there were no complicating factors over transit rights either into or out of the countries, and thus no issues which could impact foreign relations with any other countries. The most significant exception to this simplified pipeline geography is Kaliningrad oblast, which is connected to the rest of Russia by pipelines running through the Baltic states. But, this exception also added to the stability of the situation, as any disagreement between the parties which could have resulted in a disruption in gas supplies to the Baltic states would also have resulted in the isolation of Kaliningrad as well.

¶7. (SBU) Comment. The Baltic states, although being rather small consumers overall, represent an important example of how Russian gas exports were able to be smoothly and successfully transitioned to a market-based system. Although the specifics of the Baltic states situation (their relative prosperity, the history of good credit, and the lack of geographic complications) are different from that of other former Soviet states, it shows the possibility exists to create a market dynamic which is mutually beneficial for both the gas importing and exporting countries.

GWALTNEY